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USE OF LETTER OF CREDIT PROCEDURES FOR PAYING  
DEPARTMENT OF DEFENSE CONTR. (U) GENERAL ACCOUNTING  
OFFICE WASHINGTON DC FINANCIAL AND GENERAL ... 18 MAY 78  
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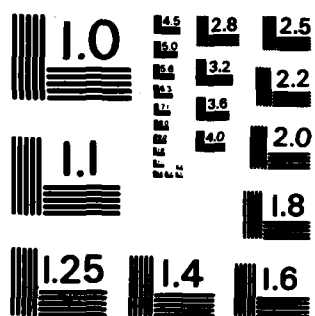
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UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

DIVISION OF FINANCIAL AND  
GENERAL MANAGEMENT STUDIES

B-39995

May 18, 1978

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Mr. Arthur Schoenhaut  
Executive Secretary  
Cost Accounting Standards Board

Dear Art:

This is in response to your request that we determine whether the Department of Defense could advantageously use letter of credit procedures for paying contracts authorized to be financed by advances and progress payments. Such payments are currently made by Treasury check.

In our meeting with you on January 27, 1977, you specifically requested that we determine if the checks paid letter of credit method would allow a more precise identification of the level of Government and contractor investment in working capital. The results of our review are summarized below.

Our findings include observations about various payment techniques and analysis of several major issues which are related to operating capital. Advances are dealt with separately as they are treated somewhat differently from progress payments. Since regulations provide that Defense reimburse contractors operating cost contracts at 100 percent, these contracts are not discussed in this report.

We believe that effective use of our findings can be made only after agreement has been reached on desired policies with respect to contractor investment in operating capital.

ADVANCES

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In making our survey we used the experience of the Energy Research and Development Administration (now a part of the Department of Energy) as a guideline because the Administration has had extensive experience in the use of letters of credit to pay advances to contractors. Administration officials told us they have saved the Government

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substantial interest costs by using the letter of credit approach.

Prior to the use of this approach, the Administration paid contractors advances by Treasury check well in advance of their need for funds. Paying the contractors before they needed the money caused the Treasury to incur additional interest costs. That extra interest costs were incurred is based on the presumption that Treasury had to borrow funds sooner than if letter of credit procedures were used. 1/ Under the Administration's letter of credit approach, savings in interest result because payments are more closely timed to contractor needs.

According to Treasury regulations it works this way. Arrangements are made between the Government agency, the contractor, and the contractor's bank, whereby the contractor receives an increase in his bank account equal to the contractor's checks for disbursement under his Government contract when the checks are honored for payment by the bank. Thus, the contractor gets his funds from the Government when he needs the money to cover the checks he has written. (We found instances, however, where some aspects of the Administration's program were not operating consistent with Treasury's letter of credit procedures. We are pursuing these areas.)

The above payment method is called the checks paid letter of credit system. There are other approaches used by the Department of the Treasury which administers the letter of credit program, but they are not discussed here because none of them offer the same degree of precision in matching Government reimbursements with contractor payments. 2/

While the use of letters of credit has proved worthwhile to the Administration in cases involving advances to

1/This is the concept of time as a factor of cost; however, Treasury borrowing often considers other factors besides the immediate need for funds. Thus, there are circumstances in which making funds available sooner would not increase interest costs.

2/Under what is called the regular letter of credit approach, the contractor estimates his current needs in advance and is advanced the amount of this estimate.

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contractors, the amount of advances to Defense contractors is too small to merit much concern. Only about 40 contractors receive advances, which for the most part, involve nonprofit educational or research institutions engaged in educational, research, or development work. Moreover, the amounts involved are small. At December 31, 1976, about \$2.4 million of such advances was outstanding. Accordingly, our principal efforts were directed toward progress payments.

#### PROGRESS PAYMENTS

Under most large Defense contracts, contractors are financed by progress payments. These payments are tied in with the progress made in completing work under the contract and are made to alleviate the burden placed on contractors to provide all working capital to finance fixed-price contracts. The standard progress payment rate is 80 percent of the total allowable costs for large firms and 85 percent for small firms.

Neither Defense nor the Administration use letter of credit procedures to pay progress payments on fixed-price contracts. In both cases such payments are made by Treasury check. Administration officials told us they believe that paying progress payments by letters of credit would speed up the outflow of cash from the Treasury, thus increasing interest costs, and would require substantial changes, with attendant costs, to the Administration's administrative and accounting procedures. Further, they noted that pertinent Treasury regulations make no provision for using letters of credit to pay progress payments but do require their use with certain advance-financed contracts. The Treasury regulations, of course, could be modified. A broader view may suggest the desirability of incurring the increased governmental costs. The basic purpose to be served must be evaluated to determine whether letter of credit or check payment procedures are more effective.

Defense's payments to contractors are based on vouchers submitted by the contractors (1) not more frequently than biweekly, (2) after approval of a Defense administrative contracting officer, and (3) in accordance with the provisions of the Armed Services Procurement Regulation (ASPR). These regulations require contractors to make certain payments, such as to subcontractors and direct material vendors, before including them on progress payment vouchers, and to include on these vouchers certain accrued costs, such as payrolls and indirect materials.

Payment of such vouchers is normally made within 10 days. Since vouchers cannot be submitted more frequently than biweekly, there is ordinarily a lag of about 2 weeks between submission and payment of the vouchers. Together with the ASPR provisions requiring that certain costs be paid yet allowing other costs to be accrued, it becomes difficult to measure the level of contractor investment in working capital.

The checks paid letter of credit method, if properly implemented and monitored, would allow a more precise identification of the level of Government and contractor investment in working capital because it would provide Government financing to contractors only when contractors' checks cleared their bank accounts. Thus, Government payments would be based on costs paid by contractors instead of, as with the present method, on costs incurred by contractors, which include accrued as well as paid expenses. This would alter the level of Government and contractor investment in working capital. Variables which affect the level of investment under the present payment system, such as the timing of payment, float, and the impact of accrued costs, would cease to be significant factors in determining the level of Government and contractor investment in working capital, thus leading to greater accuracy in identifying the level of contractor investment.

The available evidence indicates that the contractor would get his funds faster under the checks paid letter of credit system, thus increasing Treasury borrowing costs. In this respect, a study of 12 fixed-price contracts which we made for Senator Proxmire (PSAD-77-48, Dec. 21, 1976) showed that at the 80-percent progress payment rate the Government provided between 68 and 77 percent of the capital required to finance the contracts. (Contractors were providing between 13 and 22 percent; payroll and vendor accruals and bank float provided the remainder.) If the checks paid letter of credit system were used, Government and contractor investment could be more uniformly kept at about 80 percent and 20 percent, respectively.

Use of the checks paid letter of credit system for fixed-price contracts having progress payments would therefore appear to enable the Government to control the contractor's investment in the contract more exactly. However, the increased interest costs related to additional public debt financing, which would result from a change to letter of credit procedures, would have to be compared with the expected benefits. Also, we cannot conclusively determine

whether a change to the letter of credit procedure for paying fixed-price contracts would be beneficial to the Government without a consideration of several other factors, the study of which was outside the scope of our survey.

The use of the checks paid letter of credit system would require Defense to change many of its accounting and reporting procedures pertaining to disbursements. Currently, the documents used to request progress payments are used as basic accounting documents. Under the checks paid letter of credit system these basic documents would not be prepared in their present form or, if they were, some reconciliation procedures would be necessary to match payments requested on vouchers with amounts disbursed by the bank to pay checks drawn on the contractor's bank account. Since many accounting systems would be involved, this could be expensive. The extent and cost to implement these changes cannot be ascertained without extensive detailed study.

The checks paid letter of credit system requires participation by each contractor's bank. Each bank would expect compensation, probably in the form of a negotiated minimum cash balance. Defense would have to commit appropriated funds to be used as negotiated cash balances, monitor these cash balances, and perform various administrative reviews on a continuing basis to assure that the compensation provided to the banks was not excessive in relation to the services provided by the banks. The cost and magnitude of this additional administrative burden is not now known.

#### POLICY CONSIDERATIONS

As discussed above, use of the checks paid letter of credit method would result in altering the level of Government and contractor investment in working capital for fixed-price contracts. Therefore, before making any changes to payment procedures, we suggest that decisions be made regarding (1) the desired relationship of Government and contractor contributions to working capital and (2) the adequacy of compensation to contractors for their investment in working capital.

In the report to Senator Proxmire cited previously, we concluded that, based on a review of 12 fixed-price contracts, we did not believe any increase in the rate of progress payments by the Government was warranted and that only a relatively small part of the contract financing had to be provided directly by contractors. We also concluded

that some contractor commitment toward financing working capital was desirable and noted that if contractor investment were reduced below a certain level, the Government would lose some of its leverage to compel performance in accordance with the contract.

We also noted that most Defense contractors, particularly smaller ones, do not have contracts qualifying for progress payments. The rationale is that where contract costs are not large and delivery is made in 6 months or less (4 months or less in the case of small businesses), private financing is generally available at reasonable rates. Presumably, the contractor's cost of this financing is included in the profit or fee negotiated with the Government.

We believe that additional study and review effort is needed to determine the magnitude of the operating capital problem in general, including a study of those contracts which do not qualify for Government financing. Such effort could expand the scope of the review we made for Senator Proxmire and should provide the information necessary to decide both the desired relationship of Government and contractor investment in working capital, and whether contractors are adequately compensated for their investment. The President's Federal cash management staff might be an ideal group to undertake this study.

After a study has been made, and working capital investment decisions have been reached, compatible payment procedures can be implemented.

#### CONCLUSION

We believe the checks paid letter of credit system would permit a more precise identification of the level of Government and contractor investment in the working capital needed to perform specific contracts. Such a change, however, would alter the existing level of Government and contractor investment in working capital. We cannot recommend a change to this method at this time because the benefits we know of do not make a persuasive case for making the rather extensive changes that would be necessary in Defense's administrative and accounting systems to accommodate the checks paid letter of credit approach.

Further, we do not believe that a decision on how to pay contractors should be made until more important decisions are reached regarding the desired level of Government and contractor investment in working capital, and



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whether contractors are adequately compensated for their investment.

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We are available to discuss this report with you or your representatives if you so desire. Since the President recently directed that a comprehensive review be made of Federal cash management policies and practices, we are sending copies of this report to the President's reorganization staff involved in a review of Federal cash management. We are also sending copies to the Secretaries of the Departments of Defense, Energy, and the Treasury, the Administrator, National Aeronautics and Space Administration, and the Director, Office of Management and Budget.

Sincerely yours,

  
D. L. Scantlebury  
Director

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